The essential guide to real estate and tax reform

Homeowners take some knocks, but not as many as they could have. And investors, companies and commercial RE stand to gain.

BY LEON LAZAROFF
JAN 16

On the road to giving corporations a historic tax cut, something had to give. In what analysts are calling a non-political sacrifice, the GOP put longstanding real estate tax breaks on the chopping block.

Indeed, the Republican overhaul of the nation's tax code, dubbed the Tax Cuts and Jobs Act and signed into law by the president on Dec. 22, is a bundle of compromises for real estate that all but rewrite federal policy on homeownership while putting more money in the pockets of agents, brokers and developers.

While the bill's authors may not have intended to transform long-established real estate tax policy, the upshot of the legislation is that federal incentives for homeownership have been remarkably reduced, though they were saved in the end from more severe gutting by the National Association of Realtors' (NAR) powerful lobbying efforts.

"We consider this a major sea change in the way federal housing policy is executed," Evan Liddiard, director of tax policy at the National Association of Realtors, said in a phone interview from Washington. "For more than 100 years, the IRS has incentivized homeownership through the mortgage interest and property tax reduction. This will change in a major way because of this bill."

Among the biggest winners in the Republican tax cut are the country's largest corporations. Companies that qualify as so-called C Corps can expect to pay $650 billion less in federal taxes over the next 10 years, according to a study by Moody's Analytics. The top marginal tax rate for those corporations was cut to 21 percent from 35 percent.

To offset that steep decline in tax revenue — money used to pay for schools, roads, police, and other public goods and services — the plan's Republican authors reduced or eliminated an assortment of tax breaks that had served to buttress the notion that the country was stronger as more people owned their own home.

At the top of the changes in the new tax law is the limiting of the mortgage interest deduction, a policy that *The Wall Street Journal* called one of the "sacred cows of the tax code". At present, a new homeowner can deduct interest on mortgages up to $1 million. The new bill lowers that threshold to $750,000 for primary and secondary residences.

Yet the lowering of the mortgage interest deduction was nearly made moot by a doubling of the standard deduction for individuals and families, which was raised to $12,000 for single filers and $24,000 for those filing jointly.

As a result, far fewer homeowners are likely to choose to itemize their deductions, and by extension, take advantage of the mortgage interest deduction.

The new law also caps the state and local deduction for property taxes (also known by the acronym SALT) at $10,000. As has been widely noted, this change will have its greatest impact in comparatively high-tax states such as California and New Jersey. Nonetheless, the cap will be felt nationwide in some form or another.

In another abrupt departure from recent real estate tax policy, the new law eliminates deductions for interest on home equity loans. Such loans, of course, have covered home renovations, college tuition bills and all sorts of purchases. Removing a deduction as widely used as interest on home equity loans threatens to make owning a home a bit less attractive, said Rodney Ramcharan, as associate professor of finance and business economics at USC's Marshall School of Business and a former executive at the Federal Reserve.

"The use of the home equity loan took a relatively illiquid asset and made it very liquid," Ramcharan said in a phone interview from Los Angeles. "Doing away with that deduction will have a big impact on the usefulness of the house as an asset. Historically, people have concentrated much of their wealth in housing. And this could very well affect that."

Had the authors of the legislations wanted to incentivize homeownership, they might have left existing deductions in place, said Nela Richardson, chief economist at Redfin, the New York-based real estate brokerage. Indeed, they could have gone in a completely different direction and offered tax credits based on income to prospective homebuyers, she said.

Ultimately, the changes wrought by the Republican majority in both houses of Congress may have had less to do with shaping national real estate policy than offsetting cuts elsewhere in the law, she added.

"This tax bill was less an indictment against homeownership than a tactical maneuver to pay for a cut on the corporate side," Richardson said. "There's really not a lot of ideology in this."

As for the real estate industry itself, the final legislation shines brightly on brokers and developers, through changes to so-called pass-through entities, like S-corporations and limited liability corporations. Under the newly enacted tax reform package, pass-throughs, often used by brokerages and other real estate entities, would be locked into a 20 percent deduction — a substantial savings given that pass-through owners currently pay taxes on these profits through the individual income tax rate.

What the tax plan means for homeowners

If the American Dream is built around homeownership, the Trump tax plan may make that dream less enticing. It may even force prospective buyers to consider whether they're better off renting rather than putting so much of their savings into an asset that just became a lot less liquid.

One thing is clear: homeowners are likely to pay more taxes on their homes, and in some cases, may see the equity value of their home decrease. Prospective buyers, meanwhile, face the prospect of having to pay more in taxes to purchase a home.

"The upshot is they'll be less likely to afford to buy it, and less likely to want to buy because they won't have the help, the subsidy, the assistance, from the tax code," Liddiard said. "This will lead us toward being a nation of home renters rather than a nation of homeowners."

Buyers will be able to deduct interest on mortgages up to $750,000, down from $1 million. While this change affects only about 4 percent of loans nationwide, its impact will be more pronounced in places with higher property values. Well over 50 percent of mortgages in resort towns and places like Manhattan, San Francisco and the western reaches of Los Angeles are valued at more than $750,000.

But because the standard deduction for all taxpayers was doubled, far fewer individuals and couples are even likely to itemize. That means they're less likely to choose to deduct for interest on their mortgages, bypassing what had historically been a leading that will hit higher-tax states the hardest.

Terminating the deduction on interest on home equity loans may prompt fewer homeowners to take out such a loan, and even to make them smaller. In turn this could dampen the market for home renovations and other purchases — whether it be a car, artwork or property investment.

In a big win for real estate, the final version of the tax plan didn't increase capital gains taxes on the sale of property. Homeowners will still be allowed to shield some of the profits from the sale of their homes: up to $250,000 for an individual and $500,000 for married couples. Earlier versions of the bill aimed to cut into those amounts.

Many of the compromises to the original GOP bill, including the capital gains tax emerging unscathed, stemmed from an ambitious lobbying campaign spearheaded by NAR, a trade organization boasting approximately 1.25 million members that inundated elected officials with more than 300,000 emails leading up to the vote. Simultaneously, NAR leaders met with legislators in Washington and targeted homeowners across 60 counties to inform them of the bill.

Credit: Keni Thomas

Credit: Keni Thomas

What the tax reform plan means for the U.S. housing market

There are many factors at play in trying to determine the impact that the Republican tax plan will have on the U.S. housing market. Will the new tax regimen make homeowners less likely to sell? Will real estate developers use their extra cash to build more starter homes, a category in comparatively short supply?

Will landlords choose to keep renting rather than sell their properties? What will that do to the rental market, and by extension the demand for homes?

Additionally, there are a handful of macro-economic factors in the mix, regardless of how the legislation plays out.

There is little doubt that the Federal Reserve will raise interest rates in 2018 — the question is by how much. As a result, mortgage rates are likely to rise, potentially dampening enthusiasm for buying a home. Of course, mortgage rates have been very low by historical standards for nearly 10 years, but no one likes to see rates rise just as they're beginning to shop for a house.

Together, the lowering of the mortgage interest rate deduction, capping property tax deductions and eliminating the home equity interest deduction may remove some of the luster from owning household real estate.

As a result of the new tax rule, Moody's Analytics expects home prices nationally to drop by as much as 4 percent by the summer of 2019. Homes in the highest valued parts of the country are likely to feel the brunt of that decline. Moody's estimates that property values in high-income counties such as Essex in New Jersey, Westchester in New York and areas in and around San Francisco could drop by as much as 10 percent.

An overriding question is whether developers will be incentivized to build more homes given changes in how they'll be able to report personal income. Developers were given more leeway in this tax plan to operate as a "pass-through" entity, thereby permitting them to declare 20 percent of their income as business revenue rather than as personal income. Additionally, the top personal income tax rate was cut to 29.6 percent from 39.6 percent.

Though real estate developers will have greater recourse to avoid paying taxes, it's unclear whether that windfall will translate into increased building. Nationally, many markets have struggled for some time with low inventory, especially for middle- and lower-middle income starter homes.

"While interest rates have been low, home prices in much of the country have been awfully high for the past few years, which should be an incentive to build," Ramcharan said. "This tax break isn't necessarily going to be make or break for developers to build — it could potentially be construed as a giveaway."

What the tax reform plan means for real estate pros' business interests

Homeowners may not benefit from the Republican tax plan, but the people who engineer transactions between homebuyers and homesellers certainly will.

As stated above, the Republican plan made it even more attractive for real estate agents and real estate developers to reduce taxes on their income through so-called "pass-through" entities. Agents need only to organize their business as a partnership, or other similar entity, thereby shifting more of their tax burden to the individual rather than the business level.

The new rules not only allow real estate agents to have 20 percent of their income taxed at a lower business rate, it also reduced the highest personal rate to 29.6 percent from 39.6 percent. The deduction will be available to individuals with an income up $207,500 for singles and $415,000 for couples. Incomes at higher levels would face a variety of limitations.

The pass-through deduction was enhanced in part to placate businesses and individuals that might otherwise not have qualified for the cut in the corporate tax rate, which applies to so-called C-Corporations, generally the largest and publicly-traded companies.

As for the real estate market, the sweeping changes to real estate tax codes could weaken demand, generating fewer transactions, which could cut into agent revenue. Weaker demand coupled with higher mortgages rates and slow inventory growth could make for a dispiriting stew.

"This tax code could just amplify the many concerns that we've had about the housing market for the last couple of years," Richardson said.

How the tax reform plan will affect commercial real estate


Credit: Keni Thomas

The tax plan's authors left an array of tax subsidies in place for commercial real estate developers and owners, who fared far better than individual homeowners. Unlike homeowners, those in the commercial real estate market didn't suffer a repeal of a longtime tax subsidy or get slapped with something new.

"Commercial real estate really dodged several bullets here," John Pickering, a partner in the real estate practice of Balch & Bingham, a Birmingham, Alabama firm focused on the Southeast, said in a phone interview. "There's nothing in here that cries out 'tremendous new opportunities that didn't exist before.' It's more like let things continue."

And that's great news for the commercial real estate industry.

The new tax law leaves unchanged the provision known as the 1031 Exchanges. Sellers of commercial properties will still be able to defer paying capital gains taxes on such sales if they use the proceeds to purchase another similar property.

Tax-free exchanges of "like-kind" property have long-fueled transactions, and are likely to continue to do so.

Though earlier versions of the Republican tax plan had eliminated the 1031 provision, the subsidy ultimately survived.

The same can't be said for personal property, which will no longer be given a deferral on capital gains.

"That was huge because a very large percentage of commercial real estate and sales are done through 1031s," Pickering said. "If that had gone away, people would try to structure deals around that, but you'd probably end up with a lot of people unwilling or unable to sell buildings because they're fully depreciated and can't afford the tax hit."

Another plus for commercial developers is that the historic tax credit also survived the Republican's rule-writing process.

Renovations of buildings listed on the national registry will continue to receive a 20 percent deduction.

and federal historic tax credits, such projects are possible. It's a scenario that's been replayed throughout urban centers, large and small, in recent years. "That's really brought our downtown back in a way that wouldn't have happened without those credits," he said.

Other credits were also maintained. Among them, the New Markets Tax Credit Program that offers subsidies for development projects that bring jobs to low-income areas. Private activity bonds were also sustained, a possible precursor to an expansive federal infrastructure bill.

As a group, real estate developers came out ahead. Like real estate agents, developers will be able to more easily establish themselves as a "pass-through" business thereby having 20 percent of their income taxed at a business rate rather than a much higher business rate.

The state of U.S. real estate tax policy

Whether the real estate tax policy has been reshaped by an overarching ideology about homeownership is unclear. As Ramacharan underscored, the Republicans didn't hold public hearings to discuss the finer points of the overhaul or what effect it might have on real estate.

"They could have lowered the corporate tax rate and done away with some of the loopholes, and made the bill as close to revenue neutral as possible without touching the housing market," he said. "But they decided not to do that."

With an array of personal tax breaks concentrated on those in higher-income brackets, the new tax plan could make available more cash for expensive homes, offsetting the lowering of the mortgage interest deduction, for instance. The federal top marginal tax rate was dropped from 39.5 percent to 37 percent, benefitting a cohort more likely to be buying a home priced at more than $1 million, or much more.

As widely noted, only those homeowners with comparatively high mortgages are likely to take the mortgage interest deduction and itemize their tax return.

Additionally, Republicans' decision to eliminate the home equity interest deduction and cap property tax deductions may have simply been a case of needing to find money to finance a tax plan that will cut $1.5 trillion over the next 10 years from the U.S. tax revenue.

"We don't believe this tax bill is about housing policy," Liddiard said. "It's about finding ways to lower corporate taxes and other taxes, and paying for it on the backs of current and prospective homeowners."

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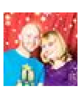

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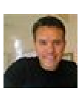

Roland Estrada · Real Estate Agent/Broker at Bennion Deville Homes Laguna Niguel, Cal BRE 01899271

I wish I could fall asleep right now and wake up on January 16th 2018. Why? Because I am just giddy with anticipation to see how handwringing nattering nabobs of negativism react when this “tax debacle” turns into a bunch of Y2K nothing.

Actually, the hand wringers will do one of two things. They will be gone with the wind. Or they will contorting themselves into a tangled mess trying to come up with all sorts of BS explanations as to why the real estate world did not come to an end because of the 2017 tax reforms.

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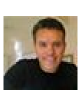

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I love the smell of chaos in the morning.

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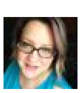

Jana Rice · Marketer at Marketing Professional

Well written!

So biased. I used to like reading articles from Inman.

Like · Reply · 10 · 1w

Chris Huff Smith · Broker/Owner at Chris Smith Real Estate Group, LLC

Couldn't agree more!

Like · Reply · 1 · 1w

Michael Reames · Real Estate Broker/Agent at Keller Williams Elite Peninsula

Completely biased. I thought I was watching CNN. Couldn't even finish the article it was so slanted.

Like · Reply · 2 · 3d

Southern Maryland Home Buying and Selling

So biased.

Like · Reply · 6 · 1w

Michael J. Kelly · Senior Sales Consultant at Keller Williams Realty, Inc.

Roland, I for one would love for you to go to sleep and wake up in about 20 years! By then I will be out of the business! I could see such moronic gibberish from a guy who sells real estate in Arkansas with their low prices, but a guy selling in Laguna Niquel? And the Capital Gains treatment was NOT left alone. It is now 5 out of 8 years for the exemption. I'm a big lover of alliteration but your use of it is something from the Alt-right playbook.

Like · Reply · 1w

Willem De Ridder · Real estate broker at Willem Sells SD

its 2 out 5 years. That did not change.

Like · Reply · 2 · 1w

Sharlene Galasso Burgess · Nanjemoy, Maryland

Wow, name calling? That is really not called for, in this arena. The govt did what everyone wanted, tax the rich! Well, there ya go. Their deduction has been reduced, so those "rich" people will pay more taxes. Isn't that what everyone wants, as they are not being taxed nearly enough? And, do you think that the 4% who have these large mortgages are going to stop buying, and start renting??! Seriously? Don't you see the spin?

Like · Reply · 5 · 1w

Roland Estrada · Real Estate Agent/Broker at Bennion Deville Homes Laguna Niguel, Cal BRE 01899271

You just made my point for me. Talk about gibberish. People at any income level that buy real estate, especially those with higher incomes don't realize long term gains because of tax write offs. They gain wealth gain because of appreciation and reduction of debt over time. Smart investors don't give a rats ass long term about tax write offs. Your ignorance and your panties are showing. You should lower your skirt before someone sees. It's an ugly sight.

Apparently I'm not the only one that sees through load of BS in this post.

Like · Reply · 1w

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Paul Stonkus · Broker/Owner/Realtor at EXIT ELITE Realty,

I was hoping I could share out content of an informative nature to my agents and clients/customers. Too bad it was written in such a biased way that I can't share it...

Like · Reply · 7 · 1w

Scott Futa · Realtor at Keller Williams Realty, Inc.

Not really hard to see through the partisan spin – journalism is dead...Inman “News”?

Like · Reply · 2 · 1w

Roland Estrada · Real Estate Agent/Broker at Bennion Deville Homes Laguna Niguel, Cal BRE 01899271

It's more like "Inman Editorial". 😉

Like · Reply · 3 · 1w

Jeff Aughey · Realtor at RE/MAX Prestige

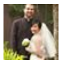
A good bit of whining in the article. No big problem for real estate. Just chill out and enjoy this great market.

Like · Reply · 5 · 1w

Stephanie Crawford · Owner/Broker/Realtor at Brokers Cooperative

I'm in Tennessee - where the state law says that brokers can only pay commissions to agents. Brokers can't pay commissions to corporations or organizatoins. Here, we can't incorporate ourselves. Are there other states out there like us? How do you see us being impacted?

Like · Reply · 1w



JB Farrell · Associate Broker/Realtor at Keller Williams Realty Lafayette

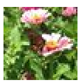
You will still get a 20% deduction off of the net income reported on your schedule C. You still get a tax break without an LLC or other corporate level structure.

Like · Reply · 4d

Charlie Ivy · Realtor at Carol Jones, Realtors

Biased.... Some comments (speculations) are without merit. AND the capital gains was RETAINED!! That alone was a coup years ago that was excessive. I benefitted from it but 2 out of the last 5 - just move from house to house as a friend did and pocket it all (and before that, you shouldn't have had to move up). No strategic investment planning, just a special interest benefit. It was partly the cause of the bubble when buyers working for a living and raising families jumped on the house buying bankwagon thinking all was well. Carried interest was not touched - protect those fund managers! Only privately invested funds should get preferential tax treatment, not the manager or general partner. Personally, I would have preferred to see the mortgage interest reduced further than than have a $10,000 cap on property tax; it could have been higher but we have to take care of the banks and the 1%... apology for the snarky attitude

Like · Reply · 2 · 1w



Wendy Wolf · Realtor/Agent at McGrew Home Team

Wake up people - these articles aren't supposed to be Pep Rallies for the Real Estate industry. Has this Administration succeeded in having us filter information for the sole purpose of supporting our already-held beliefs? If the news piece/article/facts don't mesh with what our views are; we discard it as "biased" or "fake news" or "lies". It appears Mr. Estrada and other who think this "really, really big" Tax Reform is no big deal are in a position (i.e. pass-thru's, developers) to benefit and will be holding their own "Pep Rallies" in the form of Team or Business Meetings telling their agents how to 'spin' this to their clients so it appears to be 'no big deal'.

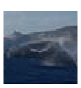
Like · Reply · 1w

Roland Estrada · Real Estate Agent/Broker at Bennion Deville Homes Laguna Niguel, Cal BRE 01899271

Before tax laws written in the last century for real estate were enacted, people bought property for appreciation, wealth building and retirement. That will not change, ever. The real estate industry will not suffer a decline in 2018 because of tax laws. Any future downturn will be part of the same cyclical corrections we have seen for the last 117 years.

And as I said to Mr Kelly. So let me guess, you will not be selling real estate any longer because you can't recommend that clients forego long term appreciation because some won't be getting certain tax write offs. And I'm sure you'll never buy another piece of property for the same reasons. What? Yeah I didn't think so. Whiny hypocrite!!

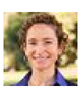
Like · Reply · 1w



Bill Morscheck · University of Idaho

Nice that Inman has written the Democratic talking points for the next election. Sad to read such a biased report on this site

Like · Reply · 4 · 1w



Hope Feinglass Egan · REALTOR®; at Keller Williams Richmond West

This was hard to read. As a former long-time individual income tax preparer and CPA, I was stunned to see such a biased article, in so many ways. A main point of the tax changes was simplication, and many homeowners(including myself) will benefit from the same (or lower) taxes with far less burden of itemizing. Who is Leon Lazaroff anyhow? I don't see any byline or writing, business or real estate credentials listed. Why does he call C-Corps and S-Corps "so-called"? The dictionary says that that this phrase is "used to express one's view that a name or term is inappropriate." Puzzling.

Like · Reply · 5 · 1w

Greg Phillips · Managing Broker at Baird & Warner

Yes, a bit biased. Small brain. If no one noticed, things are booming in the economy. This spin in this is pathetic.

Like · Reply · 6d

Frank Consulting Group - 1 Great Idea LLC

It's sad that the worst part of this article isn't the shameless, partisan rhetoric and spin. The worst part is the misinformation, lies and deceit perpetuated and fueled by supposed "news" organizations like Inman.

This shouldn't surprise anyone. It's been this company's consistent modus operandi for many years.

Inman is incapable of disclosing the truth behind their political ideology (because they think their ideology is better than yours) about as much as Realtor dot com can admit the truth behind their bogus listing advertising and lead sale strategies. We all know the deal (some of us intimately) but when it's shoved in your face so intentionally as if to give a figurative middle finger, it's prudent to speak out a little bit.

Like · Reply · 4d

“putting more money in the pockets of agents, brokers and developers.” hmmm
Redfin is Seattle based not New York

Like · Reply · 4d

Scott Myers · Owner at Century 21 Scott Myers, Realtors

There is no reason for agents to set up LLCs or S Corporations. They still get the 20% credit the same as pass through corporations do. Texas and perhaps other states have requirements that make it difficult for an agent to incorporate, but that really will not matter.

Like · Reply · 3d

Scott Lawhun · Real Estate Agent at Keller Williams Realty Black Hills

It is interesting to see the lamenting over a shortage of housing inventory transition into how the new tax laws will cause people to abandon home ownership for renting. Won't this help solve the inventory problem? Is the American dream the ability to itemize their taxes or to own their own home and build equity? Is it good that owners are not encouraged to use their home as an ATM to buy art, etc.

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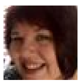

Lisa Price · Lancaster, California

Maybe the article seems "slanted" to some here. Well, that's probably because the tax code is slanted to favor big business over lowly little homeowners. Yeah, the economy "boomed" in the 80s too under Savior Reagan ... which fueled the biggest income inequality ever. The public's earning power has been diminished since then while big business gives away jobs overseas and hides their fortunes off shore. Time will tell that this "new" tax scheme does not help increase wealth among the general public, but I'm sure the Trump and all his buddies are stuffing their pockets as fast as they can. Deve... See More

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